



February 14, 2006

AGENDA ITEM 6c

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Executive Compensation Strategic Plan Update
Macro Economic Initiatives
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Information Only
- IV. ANALYSIS:**

Executive Summary

This agenda item is the second update of CalPERS' progress to implement executive compensation reform as it pertains to the following macro economic strategies of CalPERS' three-year Executive Compensation Strategic Plan:

- 1. SEC engagement
- 2. SRO/Exchange engagement
- 3. Compensation consulting industry engagement

This agenda item updates the Committee on each of the three strategies. A separate update is provided to the Committee on the micro economic strategies.

Background

Compensation programs are one of the most powerful tools available to align the interests of executive managers with those of shareowners. Since shareowners have a strong interest in long-term performance, CalPERS believes the marketplace should move to a pay-for-performance based model. In recognition

of this, on November 15, 2004, CalPERS' Investment Committee approved a three-year Corporate Governance Executive Compensation Strategic Plan (Attachment 1) in order to raise the level of accountability of public company boards and compensation committees to shareowners.

Staff has committed to providing periodic updates to the Investment Committee on the progress of CalPERS' efforts to implement executive compensation reform as it pertains to the following macro and micro economic strategies:

Macro Economic Strategies:

1. SEC engagement
2. SRO/Exchange engagement
3. Compensation consulting Industry engagement

Micro Economic Strategies:

1. Promoting reform at the largest companies
2. Enhancing compensation committee accountability
3. Recognizing pay-for-performance leaders

Staff continues to implement CalPERS' Executive Compensation Strategic Plan with the intention of providing periodic updates to the Investment Committee. This is the second update on staff's progress since inception of the three-year strategic plan.

Executive Compensation Strategies Update

3 Macro Economic Strategies

1) SEC engagement – The Committee approved the following objectives:

- Develop and submit to the SEC a comprehensive proposal for increased disclosure related to executive compensation in 2005.
- Coordinate broad institutional investor collaboration to support SEC rule making for increased executive compensation disclosure.

CalPERS has engaged the SEC as part of a collaborative effort involving both large institutional investors and leading institutions in the compensation consulting industry. There were two separate initiatives. One was a letter (Attachment 2) sent to the SEC on behalf of an institutional investor group. The second resulted in recommendations (Attachment 3) to the SEC on behalf of both a subset of the largest executive compensation consulting firms and a group of the largest institutional investors in the U.S.

Attachment 2 is a letter CalPERS signed as part of the International Roundtable on Executive Remuneration regarding enhanced disclosures on executive

compensation. The specific recommendations contained in the letter pertained to disclosure, transparency, pay-for-performance practices and accountability by members of the compensation committee. Each recommendation is consistent with CalPERS' Executive Compensation Strategic Plan.

Signatories to the letter include ten institutional investors from the United States, Canada and Europe. In aggregate, the investor group manages nearly one trillion dollars, much of which is invested in the United States.

A list of the signatories is shown below:

- California Public Employees' Retirement System (US)
- California State Teachers' Retirement System (US)
- Co-operative Insurance Society (UK)
- New York State Common Retirement System (US)
- New York City Pension Funds (US)
- Ontario Teachers' Pension Plan (Canada)
- RAILPEN Investments (UK)
- State Board of Administration of Florida (US)
- Stichting Pensioenfond ABP (Netherlands)
- Universities Superannuation Scheme Ltd (UK)

Attachment 3 represents a collaborative recommendation on executive compensation transparency by a group of institutional investors and executive compensation consulting firms, coordinated by CalPERS. The group is shown below.

Institutional Investors

- California Public Employees' Retirement System
- TIAA-CREF
- Legg Mason
- Fidelity Management & Research Company
- The Vanguard Group

Compensation Consultants

- Towers Perrin
- Watson Wyatt Worldwide
- Hewitt Associates
- Mercer Human Resource Consulting

The group of Institutional Investors and Compensation Consultants were able to meet with Mr. Allen Beller, Director-Division of Corporation Finance, and several members of his staff at SEC headquarters in Washington, DC on October 18, 2005. Prior to the meeting with the SEC, TIAA-CREF and The Vanguard Group relinquished involvement in the initiative.

The meeting provided an opportunity for the group to present its joint recommendation to the SEC on executive compensation disclosure and to engage in dialogue with SEC staff on questions and issues they were facing on this topic. As a result of this successful meeting with the SEC, the group of institutional investors and compensation consultants were asked to provide SEC staff with follow-up recommendations and input on the following:

- Strengthening the Performance Graph contained in the Proxy Statement.
- Strengthening the Compensation Committee Report contained in the Proxy.
- Improving director compensation disclosure practices.
- Identifying the preferred valuation method for perquisites.
- Assessing the usefulness of a Management, Discussion and Analysis (MD&A) approach for the Compensation Committee Report.

In response to the SEC request, recommendations were provided to the SEC pertaining to the points noted above (Attachment 4).

The SEC held a hearing on January 17, 2006 to discuss its soon to be released Rule Proposal for amending rules governing executive compensation disclosure practices. Staff will review and comment on the SEC Rule Proposal once it is officially released to the Federal Register.

2) SRO/Exchange engagement – The Committee has approved the following objectives:

- Engage national SROs/Exchanges to seek support in the development of executive compensation disclosure requirements.
- Advocate the enhancement of exchange listing standards that incorporate compensation philosophy and practice to better align boards and management of listed companies with shareowners.

Staff has met with the current leadership at the NYSE to encourage the involvement of the Exchange in improving transparency in executive compensation of listed companies. While there was broad philosophical agreement that much improvement is needed, the Exchange was noncommittal in incorporating any formal policies into exchange listing standards. Staff will continue to seek opportunities that support the development of executive compensation disclosure requirements.

3) Compensation consulting industry engagement – The Committee has approved the following objectives:

- Take a leadership position in coordinating institutional investor support to develop a focused approach of engaging and communicating investors' compensation program preferences to the compensation consulting industry.
- Educate the compensation consulting industry with a better understanding of shareowner preferences for how companies utilize executive compensation to better align boards and management with shareowners.
- Affect compensation consulting practices to address executive compensation reform by engaging major compensation consulting firms.

At the August 15, 2005 Investment Committee meeting, staff provided an update noting engagement underway with the executive compensation consulting industry. The purpose of this engagement was to focus on issues of transparency and overall pay-for-performance metrics.

Over the course of the 2005 calendar year, CalPERS along with the investor group listed under #1 above met with the compensation consulting firms three times and discussed executive compensation issues of mutual concern. Among the issues discussed were preferred compensation disclosure/transparency models, understanding the role of the compensation consultant, financial metrics, equity vesting requirements, and peer group analysis. Staff intends to continue to engage the executive compensation consulting industry along with the institutional investors listed above.

Letter From California State Controller Steve Westly

On January 31, 2006, California State Controller Steve Westly sent a letter (Attachment 5) to the CalPERS Board of Administration urging the System to fight against corporate abuses by working to make "clawbacks" the norm in executive compensation agreements. Clawback provisions provide for the recoupment of merit-based compensation awarded on the basis of misstated or fraudulent company performance. CalPERS' approved corporate governance principles and guidelines do not currently address clawback provisions. However, CalPERS has historically supported shareowner proposals requesting the adoption of clawback provisions. Controller Westly also requested the Board to formally support Representative Barney Frank's "Protection Against Executive Compensation Abuse Act." Staff will provide an oral update on Barney Frank's proposed legislation at the February 14, 2006 meeting.

Summary

Over the course of the past 15 months, staff has met with the New York Stock Exchange, the Security and Exchange Commission, numerous investor groups and the largest executive compensation consulting firms in order to effect change in pay-for-performance standards as well as disclosure and transparency for shareowners. These efforts are all ongoing. In addition, staff will be providing commentary to the SEC on the proposed rule on executive compensation disclosure. An update of the three micro economic strategies will be provided to the Investment Committee in a separate agenda item.

IV. STRATEGIC PLAN:

This item is consistent with the Strategic Plan: Goal I, exercise global leadership to ensure the sustainability of CalPERS' pension and health benefit systems.

V. RESULTS/COSTS:

Staff anticipates that existing resources are sufficient to support this effort.

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